

NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW OF
NEW LONDON SECURITY
FEDERAL CREDIT UNION

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EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) conducted a Material Loss Review of New London Security Federal Credit Union (New London). We reviewed New London to (1) determine the cause(s) of the credit union's failure and the resulting loss to the National Credit Union Share Insurance Fund (NCUSIF); and (2) assess NCUA's supervision of the credit union. To achieve these objectives, we analyzed NCUA examination and supervision reports and related correspondence; interviewed management and staff from NCUA Region I; and reviewed NCUA guidance, policies and procedures, NCUA Call Reports, and NCUA Financial Performance Reports (FPR).

We determined suspected fraud was the direct cause of New London's failure due to a misappropriation of credit union investment funds. As of June 30, 2008, the credit union had \$12.7 million in assets and investments accounted for \$12.1 million of the total assets. NCUA discovered that approximately \$12 million in investments did not exist and that investment brokerage statements appeared to be fabricated. New London's investment account manager served on New London's Board of Directors for 19 years. The account manager controlled substantially all of the investment activity and blank investment statements were discovered in the account manager's office. The account manager also hand delivered the investment statements to the credit union. In addition, a former credit union manager stated that the investment account manager asked her to type information onto blank investment statements. The 82-year old account manager committed suicide on July 28, 2008, the day of NCUA's liquidation of New London.

We also determined New London management failed to implement adequate internal controls over the credit union's investment activity. Specifically, management allowed the account manager to handle all investment activity without adequate oversight. For example, the account manager made the investment purchase and sale decisions, executed investment transactions, and submitted reports and recommendations to the Board—with little or no credit union oversight. Beyond contracting with external auditors to perform annually required work, the credit union Supervisory Committee was inactive for more than four years. NCUA Documents of Resolution repeatedly recommended that the Supervisory Committee become more active or contract out quarterly reviews for such things as internal control reviews. Moreover, the Board repeatedly promised to contract out quarterly reviews; however, this never occurred.

In addition, New London management repeatedly failed to take timely corrective actions on NCUA Documents of Resolution. NCUA recommended that the credit union execute a safekeeping/custodial agreement with a third party independent of the account manager. According to NCUA examination documents, the New London board passed a resolution to have a safekeeping arrangement with its investment brokerage firm and the credit union's attorney reviewed this agreement to ensure the credit union's interests were protected. However, NCUA staff was unable to locate a written safekeeping agreement, which could have shown that the credit union's interests were protected.

Furthermore, although the external auditor purportedly obtained annual independent confirmations from the brokerage firm, the confirmations received were not sufficient to ensure the investments existed. We determined there were several confirmation responses the external auditor should have questioned and performed additional confirmation procedures. For example, one confirmation request was mailed to the brokerage firm's headquarters in St. Louis, Missouri, but the confirmation response received was from the account manager's office in Waterford, Connecticut. Additionally, for the six years of confirmations we reviewed, two confirmations were not signed and the last two years' confirmations were not in the external auditors' work papers. The external auditors failed to challenge the third-party confirmations, thereby allowing the suspected fraud to go undetected.

Finally, we determined that NCUA examiners did not adequately evaluate the risk in the New London's investment program. Investments accounted for over 90 percent of the credit union assets. While NCUA examiners noted the high concentration of investments and the lack of controls over investments--including the lack of a safekeeping agreement, they failed to elevate these repeated issues for stronger supervisory actions. Consequently, examiners did not expand examination procedures when they should have done so. In addition, NCUA examiners did not review or document external auditor work papers. We found instances where NCUA examiner work paper documentation contradicted the information found in the external auditor's work papers. Again, NCUA examiners did not ensure that credit union management took corrective action on repetitive Document of Resolution issues by elevating those issues to their superiors for stronger supervisory actions. Finally, the NCUA quality control review did not ensure that the examiner took the recommended corrective actions. As a result, NCUA missed opportunities to mitigate the loss to the NCUSIF caused by New London's failure.

In addition, we reviewed industry observations regarding occupational fraud. We believe the industry's observations apply directly to issues we observed during our review. We determined New London's lax internal control environment created an environment susceptible to fraud. Our comparative analysis can be found in [Section C](#) of this report.

We are not making recommendations. Instead, as major causes, trends, and common characteristics of financial institution failures are identified in our reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the NCUA's supervision program and make recommendations, as warranted.

We appreciate the courtesies and cooperation NCUA management and staff provided to us during this review.

BACKGROUND

New London Security Federal Credit Union

New London Security Federal Credit Union (New London), located in New London, Connecticut, was chartered as a Federal credit union (FCU) in 1936. As of June 30, 2008, the credit union reportedly had approximately \$12.7 million in total assets with net investments totaling approximately \$12 million. At the time of its failure, New London had 365 members and with over 94 percent of its assets in investments, the credit union operated primarily as an investment club.

New London was a small credit union where member deposits were limited to one hundred dollars per month. The credit union had one employee, a manager, who handled most of the credit union's business activities such as manually maintaining the credit union's books and records and authorizing and posting cash receipts and disbursements. New London also had five Board members and three Supervisory Committee members. In 1988, New London changed investment brokerage firms¹ and the firm's account manager who managed the credit union's portfolio, also served on New London's Board of Directors from 1985 to 2004.

On July 28, 2008, the NCUA Board placed New London into involuntarily liquidation pursuant to section 207(a)(1)(A) of the Federal Credit Union Act² (FCU Act) and appointed itself as liquidating agent. New London's failure resulted in a loss to the NCUSIF of approximately \$9.6 million.

NCUA Examination Process

Total Analysis Process

NCUA uses a total analysis process that includes: collecting, reviewing, and interpreting data; reaching conclusions; making recommendations; and developing action plans. The objectives of the total analysis process include evaluating CAMEL³ components, and reviewing qualitative and quantitative measures.

NCUA uses a CAMEL Rating System to provide an accurate and consistent assessment of a credit union's financial condition and operations. The CAMEL rating includes consideration of key ratios, supporting ratios, and trends. Generally, the examiner uses the key ratios to evaluate and appraise the credit union's overall financial condition. During an examination, examiners assign a CAMEL rating, which completes the examination process.

¹ In October 2007, New London's investment brokerage firm was acquired by another firm.

² 12 U.S.C. §1787(a)(1)(A).

³ The acronym CAMEL is derived from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset/Liability Management.

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis,⁴ trend analysis,⁵ reasonableness analysis,⁶ variable data analysis,⁷ and qualitative data analysis.⁸ Numerous ratios measuring a variety of credit union functions provide the basis for analysis. Examiners must understand these ratios both individually and as a group because some individual ratios may not provide an accurate picture without a review of the related trends.

Financial indicators such as adverse trends, unusual growth patterns, or concentration activities can serve as triggers of changing risk and possible causes for future problems. NCUA also instructs examiners to look behind the numbers to determine the significance of the supporting ratios and trends. Furthermore, NCUA requires examiners to determine whether material negative trends exist; ascertain the action needed to reverse unfavorable trends; and formulate, with credit union management, recommendations and plans to ensure implementation of these actions.

New London received composite CAMEL code 2 ratings in 2002, 2003, and 2007. From 2004 through 2006, the credit union received composite CAMEL code 3 ratings. (See [Appendix A Table A-1](#) for New London's CAMEL ratings.)

Risk-Focused Examination Program

In May 2002, NCUA announced its new Risk-Focused Examination (RFE) Program, for implementation in the fall of 2002. Risk-focused supervision procedures often include both off-site and on-site work that includes reviewing off-site monitoring tools and risk evaluation reports. The RFE process includes reviewing seven categories of risk: *Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, and Reputation*. Examination planning tasks may include (a) reviewing the prior examination report to identify the credit union's highest risk areas and areas that require examiner follow-up; and (b) analyzing Call Report and FPR trends. The extent of supervision plans depends largely on the severity and direction of the risks detected in the credit union's operation and on management's demonstrated ability to manage those risks. A credit union's risk profile may change between examinations. Therefore, the supervision process encourages the examiner to identify those changes in profile through:

- Review of Call Reports,
- Communication with credit union staff,

⁴ Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.

⁵ Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.

⁶ As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.

⁷ Examiners can often analyze an examination area in many different ways. NCUA's total analysis process enables examiners to look beyond the "static" balance sheet figures to assess the financial condition, quality of service, and risk potential.

⁸ Qualitative data includes information and conditions that are not measurable in dollars and cents, percentages, numbers, etc., which have an important bearing on the credit union's current condition, and its future. Qualitative data analysis may include assessing lending policies and practices, internal controls, attitude and ability of the officials, risk measurement tools, risk management, and economic conditions.

- Knowledge of current events affecting the credit union.

On November 20, 2008, the NCUA Board approved changes to the risk-based examination scheduling policy, creating the 12-Month Program.⁹ NCUA indicated these changes were necessary due to adverse economic conditions and distress in the nation's entire financial structure, which placed credit unions at greater risk of loss. The NCUA stated that the 12-Month Program will provide more timely relevant qualitative and quantitative data to recognize any sudden turn in a credit union's performance.

Objective, Scope and Methodology

The FCU Act¹⁰ requires the NCUA's OIG to conduct a material loss review when the NCUSIF incurs a material loss with respect to an insured credit union. The Act defines a material loss as (1) exceeding the sum of \$10 million and (2) an amount equal to 10 percent of the credit union's total assets at the time at which the Board initiated assistance or was appointed liquidating agent. In addition, the OIG has discretion to perform material loss reviews when the loss is less than \$10 million. The estimated loss of \$9.6 million did not exceed the \$10 million threshold; however, the loss accounted for 76 percent of New London's assets, which far exceeded the 10 percent threshold and the cause of the credit union's failure was suspected fraud. Consequently, NCUA OIG initiated a Material Loss Review.

The objectives of our review were to (1) determine the cause(s) of New London's failure and the resulting loss to the NCUSIF, and to (2) assess NCUA's supervision of the credit union. To accomplish our objectives we conducted fieldwork at NCUA's headquarters in Alexandria, VA and the regional office in Albany, NY. Our review covered the period from September 2002 to July 2008, New London's liquidation date.

To determine the cause of New London's failure and assess the adequacy of NCUA's supervision we:

- Analyzed NCUA examination and supervision reports and related correspondence;
- Reviewed external auditor work papers;
- Interviewed NCUA staff; and
- Reviewed NCUA guidance, policies and procedures, Call Reports (5300 Reports), and FPRs.

We used computer-processed data from NCUA's Automated Integrated Regulatory Examination Software and Credit Union Online systems. We did not the test controls

⁹ The 12-month program requires either an examination or a material on-site supervision contact within a 10 to 14 month timeframe based on risk-based scheduling eligibility.

¹⁰ The FCU Act §216(j), 12 U.S.C. § 1790d(j).

over these systems. However, we relied on our analysis of information from management reports, correspondence files and interviews to corroborate data obtained from these systems to support our audit conclusions.

We conducted this audit from February 2009 through October 2009 in accordance with generally accepted government auditing standards and included such tests of internal controls, as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Management reviewed a discussion draft of this report. We incorporated their suggested changes where appropriate.

RESULTS IN DETAIL

We determined embezzlement of the credit union's investment funds was most likely the cause of New London's failure. We also determined that New London management's actions and the actions of New London's external auditors facilitated the suspected fraudulent activity. In addition, we determined had NCUA examiners taken stronger supervisory actions regarding New London's lack of internal controls, NCUA may have detected the suspected fraud sooner and potentially mitigated the loss to the NCUSIF.

A. Why New London Security Federal Credit Union Failed

Suspected Embezzlement of Investment Funds

We determined a suspected fraudulent act caused the credit union to fail. Specifically, the account manager was suspected of embezzling approximately \$12 million from the credit union's investment account portfolio. This resulted in an estimated loss of \$9.6 million to the NCUSIF.

During the June 2008 examination, an NCUA examiner who had been recently assigned to New London¹¹ became concerned with the excessive terms of some of the investments in the credit union's \$12 million portfolio. The examiner questioned the suitability of the investments and became further concerned when the credit union manager could not answer any questions about the investments. In addition, the examiner noted the printing on the credit union's investment statement looked odd. Further, the examiner determined New London's investment activity on its general ledger had not been updated since February 2008.

In addition to conducting the regular examination process, the examiner requested that the credit union manager provide copies of the brokerage statements and investment trade tickets. The examiner then requested assistance to confirm the value and permissibility of the investments and continued the regular examination process. Accordingly, examiners began to review the credit union's general ledger, investment brokerage statements, and other documentation. As a result, examiners identified the following:

- New London's brokerage statements and its general ledger listed called investments,¹² which should not have been listed because the credit union did not own the investments;
- Investment trade tickets did not show the investments were callable and could therefore be redeemed at anytime by the issuer; and

¹¹ NCUA guidelines require examiners-in-charge rotate credit unions on a four calendar year time period basis. A different examiner had conducted the four previous regular examinations prior to the June 2008 examination.

¹² A callable investment is a municipal, corporate, federal agency, or government security that gives the issuer of the bond the right to redeem it at a predetermined price, at a specified time, prior to maturity.

- Investment trade tickets and brokerage statements appeared to have been altered.

New London received monthly brokerage statements for two accounts. One account was the investment account and the other was a deferred compensation account. NCUA examiners compared both June 2008 statements to each other and noticed that the investment statement differed in appearance from the deferred compensation statement. By comparing the statements and interviewing the involved parties, examiners found:

- The investment statement letterhead listed only the investment firm, while the deferred compensation statement letterhead listed both the investment firm and the firm that acquired the investment firm in 2007;
- The investment statement contained manually typed information, while the deferred compensation statement was computer-generated;
- The account manager hand delivered the monthly investment statements to the credit union whereas the deferred compensation statements were mailed to the credit union; and
- The credit union's previous manager, who had since retired, typed up the investment statements for the credit union's account manager.

After reviewing the original statements and supporting documentation, examiners visited the investment firm's local brokerage office to verify the existence of the investment account. Examiners found that according to the investment firm, the credit union did not have an investment account worth \$12 million. Specifically, examiners determined the existence of one brokerage account, the New London Security FCU Deferred Compensation account, which as of July 2008 held approximately \$55 thousand in investments. The assistant manager for the investment firm told examiners the account number used for the investment account did not belong to the credit union. Examiners later determined that the account number used by the credit union's account manager was actually the account number for a shoe company, which was owned by the family of the account manager's wife.

The investment firm's Senior Regulatory Counsel confronted the account manager regarding the credit union's brokerage statements. According to Counsel, the account manager denied knowing anything about the statements and denied hand delivering the investment statements to the credit union. Subsequently, the account manager committed suicide on the day of liquidation. A criminal investigation, which was closed because the account manager committed suicide, led to the discovery of evidence suggesting the credit union's account manager was involved in the suspected fraud. For example, blank investment brokerage statements, similar to those used in the conduct of the suspected fraud, were found in the account manager's office.

Lack of adequate internal controls

We determined New London management, which includes the Board of Directors, Supervisory Committee and the Credit Union Manager, failed to implement adequate internal controls. Specifically, management allowed the account manager to handle investment activity without adequate oversight. In addition, the credit union's Supervisory Committee was ineffective, investment safekeeping was not segregated from investment activity, and management did not have adequate controls in place to ensure the legitimacy of the investments. As a result, the account manager was able to conduct the suspected fraud for an undeterminable period.

New London management failed to provide adequate oversight over its investment account

We determined New London's internal controls were limited, which resulted in a lack of oversight over the broker and the investment activity. Specifically, the account manager for the New London investment account made the investment purchases and sales, collected investment income, hand delivered monthly brokerage statements to the credit union and submitted reports to the board on investment activity and status. As a result, the account manager was in a position to conceal any improper or fraudulent activity.

As previously discussed, New London was a small credit union operating as an investment club due to the fact that over 94 percent of its assets were in investments. According to NCUA guidance, when small credit unions have difficulty segregating duties, the board or the supervisory committee must become involved to ensure there are checks and controls over credit union activities.¹³

Although the credit union board authorized investment purchases and sales, a review of board minutes and statements made by the credit union manager indicated the account manager made all investment decisions.

New London's Supervisory Committee provided limited oversight

New London's Supervisory Committee provided limited oversight for more than four years. Specifically, the credit union's Supervisory Committee did not provide sufficient oversight of Prompt Corrective Action (PCA) compliance, risk management needs, operational issues, and internal controls dating back to June 2004.

According to NCUA guidance, supervisory committees are responsible for ensuring that credit union Boards of Directors and management establish practices and procedures that sufficiently safeguard member assets.¹⁴ In addition, the supervisory committee must determine whether policies and control procedures are sufficient to safeguard against error, conflict of interest, self-dealing, and fraud.¹⁵ Furthermore, federally insured credit unions are required to obtain a supervisory committee audit at least once

¹³ NCUA Federal Credit Union Handbook, part V, pg 35 Methods and Procedures section.

¹⁴ NCUA Rules and Regulations Section 715.3(a)(2).

¹⁵ NCUA Rules and Regulations Section 715.3(b)(4).

every calendar year.¹⁶ If an audit is performed or contracted out, a review of the structure of the credit union's internal controls and accuracy of the credit union's records must be performed.¹⁷

We determined New London's Supervisory Committee contracted with external auditors to perform annually required audits and reviews. However, the supervisory committee did not take necessary corrective actions or perform their due diligence in monitoring the credit union's operations to ensure member assets were protected. Specifically, in Document of Resolution (DOR) items prepared during four consecutive¹⁸ examinations, examiners recommended that the Supervisory Committee perform periodic and/or quarterly reviews of New London's various operations. In addition, these same DORs, except for the March 31, 2006 examination, stated the supervisory committee needed to maintain meeting minutes and obtain on-going training. (See [Appendix C, Table C-1](#) for DOR items related to this report.)

Further, we believe the Supervisory Committee and the Board did not take corrective actions regarding issues identified by the external auditor. From June 2003 through June 2007, the external auditor repeatedly addressed the lack of segregation of duties over cash activities and the lack of Supervisory Committee periodic reviews through management letters. We also reviewed the external auditor's work papers and determined they performed very limited reviews of New London's internal controls. Although these limited reviews appeared to have documented an understanding of New London's internal control environment, we believe the external auditors did not test the controls to ensure their effectiveness.

During the September 30, 2003, examination, the examiner did not review the Supervisory Committee minutes because the minutes did not exist. During the June 30, 2004, and March 31, 2005, examinations, Supervisory Committee checklists indicated that the Supervisory Committee was inactive and the examiner noted he was not comfortable with the Supervisory Committee's lack of familiarity with credit union operations. Finally, during the March 31, 2007, examination, the examiner could not review the Supervisory Committee minutes because the committee had not met.

We believe the Supervisory Committee and the Board did not take the necessary corrective actions to ensure internal controls were stronger. As a result, member assets were not protected and the suspected fraud continued undetected and undeterred.

Investment account activity and investment safekeeping not segregated

New London management did not ensure there was a separation of functions between investment safekeeping¹⁹ and managing the investment account. According to the examiner work papers, a credit union Board resolution allowed its brokerage firm to

¹⁶ NCUA Rules and Regulations Section 715.4, 715.5, 715.7.

¹⁷ Supervisory Committee Guide 4.03.

¹⁸ The four consecutive examinations were June 30, 2004, March 31, 2005, March 31, 2006, and March 31, 2007.

¹⁹ Safekeeping is the holding of a client's securities on their behalf in the client's name.

perform both the investment safekeeping and managing the investment account activity for New London. Consequently, these two investment functions were not independent of each other. In addition, examiners could not locate a written safekeeping/custodial agreement. We believe that had an independent third party been used for investment safekeeping, the loss to the NCUSIF may have been mitigated.

NCUA regulations require that a credit union’s written investment policies address third-party safe keepers used by Federal credit unions.²⁰ NCUA regulations also address internal controls regarding how credit unions conduct investment trading activities, including segregation of duties.²¹ In addition, NCUA guidelines state that purchased investments must be in the credit union’s possession, recorded as owned by the credit union through the Federal Reserve Book-Entry System, or held by a board-approved safe keeper under a written custodial agreement.²² New London did not meet any of these requirements.

The investments were held in street name²³ by the account manager and not in a secured area under dual control or in a safekeeping agreement with an independent third party. During the September 30, 2002, examination, and repeated in both the June 30, 2004, and March 31, 2005, examinations, the examiner identified as a DOR item the need for an independent, reliable, investment safekeeping agreement. (See [Appendix C Table C-2](#) for details.) According to the examiner, New London’s Board passed a resolution to have a safekeeping agreement with the brokerage firm. The examiner indicated that the credit union’s attorney had reviewed the agreement to ensure the credit union’s interests were protected. However, NCUA was unable to locate a copy of the safekeeping agreement.

We believe a truly independent and properly executed investment safekeeping agreement would have strengthened internal controls and may have prevented the suspected fraud from occurring. We also believe New London’s management and Board did not sufficiently address internal control weaknesses, by ensuring that the required custodial agreement was properly executed and protected the credit union’s investments. ([Appendix C Table C-3](#) shows the repetitive DORs for legal review.)

External Auditor’s Failure to Act Allowed the Suspected Fraud to Go Undetected

We determined that the external auditor’s annual independent confirmations, which it purportedly received from the brokerage firm, were not sufficient to ensure the investments existed. Specifically, we determined there were several confirmation responses for which the external auditor should have questioned the authenticity and performed additional confirmation procedures. We believe

²⁰ NCUA Rules and Regulations Section 703.3(i).

²¹ NCUA Rules and Regulations Section 703.3(k)(7).

²² NCUA Rules and Regulations Section 703.9(a).

²³ Securities held in street name are registered in the name of the brokerage firm on the issuer’s books, and the brokerage firm holds the security for the client in book-entry form.

that had the external auditors challenged the third-party confirmations, the suspected fraud may have been detected sooner, and consequently, the loss to the NCUSIF could have been mitigated.

According to auditing best practices, the auditor should direct the confirmation request to a knowledgeable third party who has oversight over the holder of the investments.²⁴ Best practices also dictate that auditors should maintain control over the entire confirmation process, from mailing out the confirmation requests to ensuring the confirmation requests are mailed directly back to the auditor.²⁵ In this case, to confirm New London’s investments, the external auditor should have mailed confirmation requests directly to the brokerage firm’s headquarters and received confirmations directly from that office.

We reviewed the external auditor’s work papers from 2002 through 2007 and determined there were several confirmation responses the external auditor should have questioned. Specifically, an investment firm representative did not sign the June 2004 confirmation response letter. The June 2005 confirmation request was mailed to the investment firm’s St. Louis headquarters; however, the unsigned confirmation letter was received from the local Waterford, Connecticut office. In addition, while neither the June 2006 nor the June 2007 external auditor work papers contained a copy of the confirmation response letter for the investment account, a confirmation response was received for the deferred compensation account for the June 2006 request. Additionally, an investment firm manager told the examiner that the local investment office never received an investment confirmation request from New London Security FCU for 2007. The manager further stated it was policy to forward confirmation requests to the St. Louis office. The external auditors should have challenged the discrepancies in the third-party confirmations. Table 1 (below) shows the external auditor’s confirmation requests and receipts by year.

Table 1: Confirmation Requests, Receipts, and Discrepancies

Exam Date	Confirmation Request Addressed to	Confirmation Response Received From	Discrepancies Found by OIG
6/30/02	St. Louis, MO office For investment account.	St. Louis, MO office	None
6/30/03	St. Louis, MO office For investment account.	St. Louis, MO office	No title under signature

²⁴ American Institute of Certified Public Accountants (AICPA) Professional Standards AU Section 330.04.

²⁵ AICPA Professional Standards AU Sections 330.26 & 330 .28.

6/30/04	St. Louis, MO office For investment account.	St. Louis, MO office	Not signed
6/30/05	St. Louis, MO office For investment account.	Waterford, CT office	Not signed Confirmation did not come from headquarters.
6/30/06	St. Louis, MO office For investment account. For Deferred Compensation account.	None St. Louis, MO office (Deferred Compensation account)	No copy of response letter in work papers (investment account) None
6/30/07	Waterford, CT office	None	Confirmation mailed to local office No copy of response letter in work papers

B. NCUA Supervision of New London Security Federal Credit Union

Weak Supervisory Actions Created Missed Opportunities

We determined NCUA examiners did not adequately evaluate the risks to New London’s investment program. Specifically:

- Examiners did not view the concentration of investments, the lack of controls over investments, or the lack of safekeeping agreements as safety and soundness concerns serious enough to warrant more aggressive supervisory action;

- We found instances where NCUA examiner work papers contradicted the information found in the external auditor’s work papers;
- Examiners should have reviewed external auditor work papers because the work papers included investment confirmations. The investments accounted for over 90 percent of the credit union’s assets;
- Examiners did not ensure credit union management took corrective action on repetitive DOR issues by elevating those issues to the Supervisory Examiner for stronger supervisory actions; and
- NCUA’s quality control review did not ensure that the examiner took the recommended corrective actions.

As a result, NCUA missed opportunities to mitigate the loss to the NCUSIF caused by New London’s failure.

NCUA’s risk focused examination process should determine the adequacy of internal controls and the degree of reliance on the work efforts completed by competent, professional individuals and documented in reports and audits.²⁶ For example, evaluating internal controls involves:

- Identifying the internal control objectives relevant to the credit union;
- Reviewing pertinent policies, procedures, and documentation;
- Discussing controls with appropriate levels of personnel;
- Observing the control environment;
- Testing transactions as indicated by the level of risk;
- Sharing findings, concerns, and recommendations with the board of directors and senior management; and
- Determining that the credit union has promptly corrected noted deficiencies.²⁷

In addition, NCUA guidance indicates examiners should base the scope, type, and depth of an internal control review on the credit union’s size, complexity, scope of activities, and risk profile. An assessment of the credit union’s audit function plays an important part in this determination. When management or examiners note internal control weaknesses, the credit union should take immediate action to correct the deficiencies.

²⁶ NCUA Examiner’s guide, Chapter 1-21.

²⁷ NCUA Examiner’s guide, Chapter 4-8.

As discussed in the background section, New London held a significant concentration of its assets, over 91 percent in investments from 2002 to 2008. ([Appendix A, table A-3](#) lists assets concentration percentages by year.) However, there were limited internal controls over the investment area. Specifically, one person controlled all investment transactions. NCUA conducted six examinations of New London between 2002 and 2007. In the examination DORs, examiners repeatedly expressed concerns over and provided recommended corrective actions regarding the lack of a safekeeping agreement and an inactive supervisory committee. However, we determined examiners did not ensure the credit union took corrective action on these repeat DOR issues. Despite New London's significant investment concentration and lack of controls over the investment portfolio, examiners did not elevate the issues to NCUA managers for stronger supervisory actions or effectively expand its supervision of New London.

Although the external auditor conducted investment confirmations, we found that the NCUA examiner never reviewed external auditor work papers to verify that investment confirmations were performed or to determine the quality of the confirmations. The examiner also did not perform an independent confirmation on the investments. The examiner stated that (1) he relied on the external auditors to perform investment confirmations as part of their opinion audits; and (2) a review of the external auditors' work papers was generally not required. Finally, the examiner never completed any of the following examination checklists:

- Investment controls;
- Investment accounting controls;
- Investment third party controls;
- Investment custodial controls; or
- Red Flag Procedures

Examiners did not view the lack of internal controls as safety and soundness concerns

Examiners did not consider New London's lack of internal controls over investment safekeeping or supervisory committee inactivity as a serious enough risk to the credit union's assets to warrant more aggressive supervision. As stated earlier, while the examiner noted that credit union's attorney had reviewed the safekeeping agreement, NCUA was unable to locate a copy of the safekeeping agreement. In addition, the custody of investments was not held independently from the account manager managing the account. Examination documentation shows the continued inactivity of the supervisory committee—in particular, its failure to conduct the recommended quarterly reviews. To compensate for New London's lack of internal controls, NCUA should have expanded its examination procedures.

According to NCUA guidance, risk is the potential that events, expected or unanticipated, may have an adverse effect on a credit union's net worth and earnings.²⁸ Transaction risk is the risk to earnings or capital arising from fraud or error that results in an inability to deliver products or services, maintain a competitive position, and manage information. This risk (also referred to as operating or fraud risk) is a function of internal controls, information systems, employee integrity, and operating processes. This risk arises on a daily basis in all credit unions as they process transactions.²⁹ In addition, transaction risk indicators include nine factors, which are:

- Board and Operational Management Understanding,
- Responsiveness to Market and Technological Conditions,
- Risk Exposure,
- Transaction Processing Controls,
- Systems and Control, Management Information Systems,
- New Products or Service,
- Conversion Management, and
- Problem Identification and Corrective Action.³⁰

During most NCUA examinations at New London, the examiners did not rate the lack of internal controls over investment safekeeping or an inactive supervisory committee as a high transaction risk. Specifically, for four of the six examinations, from 2002 through 2007, examiners rated transaction risk as moderate. However, the examiner rated transaction risk high on the September 30, 2002, examination because of the concerns over the safekeeping agreement; and on the June 30, 2004, examination he rated transaction risk high because of supervisory committee inactivity. According to the supervisory examiner (SE), examiners did not rate transaction risk high because the external auditor did not indicate any concerns regarding the safekeeping of investments or with the investment existence. In addition, the SE stated that because there were no major recordkeeping issues, there appeared to be very little risk. The SE also commented that when credit union management contracted with their external auditors in September 2006 to perform quarterly internal control reviews, transaction risk was not rated high. [Appendix A, Table A-2](#) contains New London's risk ratings.

We assessed the examinations from 2002 through 2007 and determined that the examiner should have rated Board and Operational Management Understanding, Risk Exposure, Transaction Processing Controls, Systems and Control, and Problem

²⁸ NCUA Examiners Guide, page 1-5.

²⁹ NCUA Examiners Guide, page 1-6 and 1-7.

³⁰ NCUA Examiners Guide, Chapter 2 Attachment 2.1.

Identification and Corrective Action as high risks. We also determined there were serious safety and soundness concerns because New London management allowed its account manager to handle all investment activities without a written safekeeping/custodial agreement with an independent third party. In addition, the supervisory committee was largely inactive and did not perform quarterly reviews since at least 2004. Furthermore, examiners should have reviewed and questioned the unsigned investment confirmations. [Appendix B](#) contains the nine factors comprising the transaction risk indicators.

Examiners did not adequately document examination results

We determined examiners did not adequately document the results of their examination and supervision contacts in the work papers. Particularly troubling were issues examiners did not document in the work papers. In these cases, we found it difficult to assess exactly what the examiner had reviewed. In other instances, examiners' work paper documentation contradicted additional information we reviewed regarding the credit union. For instance, we found:

- Examiners' work papers indicated the credit union's attorney reviewed the investment safekeeping agreement. However, we found no evidence that a safekeeping agreement existed;
- The examiner noted on a Supervisory Committee Audit Verification checklist that there were no internal control findings or material weaknesses; however, the external auditor noted the credit union had internal control issues. In addition, we believe the credit union's severe lack of internal controls such as the supervisory committee inactivity, failure to segregate duties, and the lack of a safekeeping agreement should have warranted a material weakness;
- No evidence showing the examiners reviewed the external auditor's work papers; and
- No evidence that New London's Board ever formally adopted written investment policies.

Examiners did not elevate repeated Document of Resolution issues for stronger supervisory actions

Examiners did not ensure New London management took corrective actions on repetitive issues detailed in DORs to prevent them from becoming problems. Specifically, supervisory committee and investment safekeeping issues identified by examiners in four of the six examinations we reviewed were continually repeated in subsequent DORs. However, examiners did not elevate those issues to the SE for stronger supervisory actions such as a Regional Director's Letter, or a Letter of Understanding and Agreement. We determined, for example, examiners did not request stronger supervisory actions to address the lack of a safekeeping agreement

with an independent third party. We believe the multiple instances of repeat DOR items and the failure to take more stringent supervisory actions resulted in missed opportunities to uncover the suspected investment fraud.

Although we determined New London's internal controls were deficient, the SE indicated there were no serious recordkeeping concerns, suspicions of fraud, or noted investment transaction concerns. The SE also indicated that the external auditors verified investments and there were few other major risks or areas of concern. As a result, repetitive issues were not elevated for stronger supervisory actions. However, the lack of internal control was high in the area of concentration risk (investments); the examiner never reviewed the external auditor verification procedures; and the requirement for a written safekeeping agreement with an independent party was not enforced.

NCUA's quality control review was ineffective

The Division of Supervision Quality Control Review, conducted following the March 31, 2006, examination, recommended the examiner expand the scope of the review to include an assessment of management's administration of the investment portfolio including the purchase and safekeeping of securities. However, the examiner did not document in the examination work papers whether any such additional procedures were performed.³¹ As a result, we could not determine whether the examiner performed the additional procedures.

³¹ Examiners are currently not required to comply with DOS recommendations.

C. Observations

This section addresses observations regarding credit union operations and management actions.

Credit Union Operations and Managements Actions

We reviewed industry observations regarding occupational fraud.³² We believe the industry’s observations apply to issues we observed during our review of New London’s failure. For example, the Association of Certified Fraud Examiners (ACFE) reported in their 2008 report to the nation³³ the implementation of

anti-fraud controls has a measurable impact on an organization’s exposure to fraud. ACFE examined 15 specific anti-fraud controls and measured the median loss in fraud cases depended on whether organizations did or did not have a given control in place at the time of the fraud. In every comparison, the ACFE found significantly lower losses when controls had been implemented. We determined New London’s lax internal control environment created an environment susceptible to fraud.

The following table lists other industry observations regarding fraud and how they compare to our observations about New London’s failure:

Industry Observations of Fraudulent Activity	NCUA OIG Observations of New London’s Failure
Lack of adequate internal controls is the most common factor that allows fraud to occur.	Lack of segregation of duties. No written safekeeping/custodial agreement. Supervisory Committee inactive.
Small businesses have been determined to be most susceptible to occupational fraud.	Lack of segregation of duties due to low number of employees. One person handling all investment activities.
Lack of management review allows fraud to occur.	Supervisory Committee inactive. Repeated DOR items not addressed. Quarterly reviews not performed.

Although, we determined that more diligent and aggressive supervision on the part of NCUA may have mitigated the loss, we believe the cause of New London’s failure was

³² The Association of Certified Fraud Examiners defines occupational fraud as “the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.”

³³ Association of Certified Fraud Examiners, 2008 Report to the Nation on Occupational Fraud and Abuse.

directly attributable to the suspected fraud committed against its members through the actions of one individual.

Observations from our review include:

Internal Control Environment was Not a High Priority

Examiners did not consistently view New London's lack of internal controls as a high transaction risk despite this issue representing an inherent problem in smaller credit unions. Prior to New London's failure, NCUA guidelines did not require additional examination procedures unless a problem presents itself. We believe the discovery of a problem may not present itself unless additional procedures are performed.³⁴ Opportunities exist to reinforce the need for additional procedures. For example, NCUA management could:

- Emphasize the importance additional procedures, such as the Red Flag review, and expanding procedures when red flags are detected. This could be accomplished through training modules at the Recordkeeping and Internal Control Subject Matter Examiner training conferences, at regional conferences and at regularly held examiner training;
- Have the Office of Small Credit Union Initiatives provide training on the importance of internal controls and the responsibilities of the Supervisory Committee during their credit union workshops and through issued guidance; and
- Stress that an independent investment custodian is extremely important when (1) examiners determine a credit union's investments are material and (2) the internal controls over a credit union's investment activity are weak and the examiner cannot confirm that the investments exist by either physical inspection or are recorded as owned by the credit union through the Federal Reserve Book-Entry System.

³⁴ NCUA Instruction 5000.20 and corresponding memo entitled Risk-Focused Examinations and Supervision – Updated Minimum Scope Requirements, requires examiners to complete the Red Flag Questionnaire at all examinations of credit unions with less than \$20 million in assets. The requirements in this instruction and memo became effective for all examinations conducted after March 31, 2009.

External Audit Work Papers Not Reviewed

Examiners did not review or document work papers developed external to the examination of New London. NCUA guidelines do not require or recommend such reviews unless a problem with the external auditor is suspected. However, we believe that if examiners rely upon the work of others--such as the supervisory committee, or internal or external auditors--then that work should be documented accordingly and made part of the NCUA examination record. Furthermore, we found:

- Examiners using the work of others to support the examination conclusions, findings and recommendations did not adequately document the review of external work papers nor make them a permanent part of the examination work papers;
- NCUA Letter to Credit Unions 03-LCU-07 provides guidance on selected provision of the Sarbanes-Oxley Act of 2002 such as audit partner rotation and management assessment of internal controls. However, the Act does not specifically apply to credit unions. While NCUA urges credit unions to periodically review their policies and procedures as they relate to matters of auditing, NCUA only encourages credit unions consider the guidance provide in the letter; and
- Requiring the periodic rotation of the external auditor or that management assess the internal controls may have mitigated the loss to the NCUSIF by exposing the non-existence of the investments sooner.

Repetitive Issues Not Elevated for Stronger Supervisory Actions

Examiners did not ensure the credit union took corrective action on repetitive Document of Resolution issues by elevating those issues to their Supervisory Examiner for stronger supervisory actions, such as a Regional Director Letter or a Letter of Understanding and Agreement. To help ensure corrective actions are taken to address Document of Resolution issues NCUA Regional management should:

- Review Document of Resolution items and determine whether the credit union officials have taken the necessary corrective actions; and
- Ensure stronger supervisory actions, such as draft a Regional Director Letter, Letter of Understanding and Agreement, etc., are taken when credit union officials have not addressed and resolved Document of Resolution items within the agreed-upon timeframe.

NCUA's Quality Control Program Ineffective

The NCUA quality control review conducted on a New London examination did not ensure that the examiner took the recommended corrective actions. The Region's Division of Supervision review recommended the examiner perform additional procedures in assessing the credit union. However, we found no evidence that the examiner performed additional procedures during subsequent examinations. To enhance the effectiveness of NCUA's quality control program:

- NCUA Regional management should ensure the actions taken by examiners to resolve recommendations from Division of Supervision Quality Control Reviews are addressed in writing.

Appendix A: Examination History

The following provides a summary of NCUA's supervision of New London, which includes examinations and onsite supervision contacts from September 2002 through the June 2008 contact during which NCUA placed New London under conservatorship.

Table A-1

New London's Assets and CAMEL Ratings – 2002 to 2008

Examination or Contact Date	Assets	Composite	C	A	M	E	L
6/30/08	\$.49M	5	5	5	5	5	5
3/31/07	12.35M	2	1	1	2	3	2
3/31/06	12.37M	3	1	1	3	4	2
3/31/05	12.37M	3	2	2	3	3	2
6/30/04	12.21M	3	2	3	4	3	4
9/30/03	12.03M	2	1	1	2	1	2
9/30/02	11.63M	2	1	1	2	3	2

C=Capital; A=Asset Quality; M=Management; E=Earnings; L=Liquidity

Table A-2

New London's Risk Ratings – 2002 to 2008

Examination or Contact Date	SR	TR	CMR	CRR	IR	LR	RR
6/30/08	High						
3/31/07	Mod.	Mod.	High	Low	Low	Low	Low
3/31/06	Mod.	Mod.	Low	Low	Low	Low	Low
3/31/05	High	Mod.	High	Low	High	High	High
6/30/04	High	High	High	Mod.	High	Mod.	Mod.
9/30/03	High	Mod.	Low	Low	High	Low	Low
9/30/02	High	High	Mod.	Mod.	High	Mod.	Low

SR=Strategic Risk; TR=Transaction Risk; CMR=Compliance Risk; CRR=Credit Risk; IR=Interest Rate Risk; LR=Liquidity Risk; RR=Reputation Risk

Table A-3

New London's Concentration of Investments to Assets – 2002 to 2008

Examination or Contact Date	Investments	Assets	Invest/Assets
6/30/08	*\$12,060,513	*\$12,741,066	94.66%
3/31/07	11,770,179	12,351,328	95.29%
3/31/06	11,998,297	12,368,613	97.01%
3/31/05	11,879,701	12,373,958	96.01%
6/30/04	11,109,717	12,205,816	91.02%
9/30/03	11,614,063	12,033,304	96.52%
9/30/02	11,159,160	11,630,297	95.95%

*Prior to adjustment for suspected fraud.

Appendix B: Transaction Risk Indicators

The following summarizes NCUA Examiner’s Guide, Chapter 2, Attachment 2.1, which provides examiners with guidance in the assignment of risk level.

Factor	Low	Moderate	High
Board and Operational Management Understanding	Fully understands all aspects of transaction risk.	Reasonably understands key aspects of transaction risk.	Does not understand, or chooses to ignore key aspects of transaction risk.
Responsiveness to Market and Technological Conditions	Anticipates and responds well to changes.	Adequately responds to changes.	Does not anticipate or take timely or appropriate actions in response to changes.
Risk Exposure	Only a slight probability of damage to reputation, capital, or earnings.	Possible loss to reputation, earnings or capital exists but is mitigated by adequate internal controls.	Weak internal controls expose the credit union to significant damage to reputation, or loss of earnings or capital.
Transaction Processing Controls	History or sound operations. Likelihood of transaction processing failures is minimal due to strong internal controls.	History of adequate operations. Likelihood of transaction processing failures is minimized by generally effective internal controls.	History of transaction processing failures. Likelihood of future failures is high due to absence of effective internal controls.
Systems and Controls	Strong control culture that results in systems, internal controls, audit, and contingency and business recovery plans that are sound.	Adequate operating and information processing systems, internal controls, audit coverage, and contingency and business recovery plans are evident.	Serious weaknesses exist in operating and information systems, internal controls, audit coverage, or contingency and business recovery plans.
MIS	Satisfactory	Minor deficiencies may exist that relate to transaction and information processing activities.	Significant weaknesses in transaction and information processing activities.
New Products or Services	Favorable performance in expansions and introductions of new products and services.	Planning and due diligence prior to introduction of new services are performed although minor weaknesses exist.	Inadequate. CU is exposed to risk from the introduction or expansion of new products and services.
Conversion Management	Conversion plans are clear, comprehensive, and followed.	Conversion plans are evident, although not always comprehensive.	CU may be exposed to processing risks due to poor conversion management, either from the integration of new acquisitions with existing systems, or from converting one system to another.
Problem Identification and Corrective Action	Management identifies weaknesses quickly and takes appropriate action.	Management recognizes weaknesses and generally takes appropriate action	Management has not demonstrated a commitment to make the corrections required to improve transaction processing risk controls.

Appendix C: Documents of Resolution

The following tables provide a summary of repetitive recommendations/DORs to correct problems identified by examiners from September 30, 2002 through March 31, 2007. The DORs are categorized by issue.

Table C-1

Supervisory Committee

Examination or Contact Date	DOR Items
9/30/02	Require CPA to review deferred compensation account for Generally Accepted Accounting Principles
9/30/03	No DOR item.
6/30/04	<ul style="list-style-type: none"> • Become active in oversight responsibilities. • Perform quarterly review of operations, including recordkeeping, underwriting, internal controls, dormant accounts, etc. or contract with external auditor to perform. • Periodically meet and maintain minutes. • Obtain on-going training.
3/31/05	<ul style="list-style-type: none"> • Become active in oversight responsibilities. • Perform quarterly review of operations, including recordkeeping, underwriting, internal controls, dormant accounts, etc. or contract with external auditor to perform. • Obtain on-going training.
3/31/06	<ul style="list-style-type: none"> • Establish quarterly audit plan with CPAs to review internal controls. • Keep written minutes.
3/31/07	Engage external auditors to perform quarterly reviews for operations, investment policy compliance, BSA/OFAC compliance, inactive accounts, recordkeeping etc.

Note: Quarterly reviews were never performed, as promised by the Board

Table C-2

Independent Investment Safekeeping/Custodial Agreement

Examination or Contact Date	DOR Items
9/30/02	Rely on an independent third party investment safekeeper.
9/30/03	No DOR item.
6/30/04	Ensure sound, independent safekeeping practices and written custodial agreement.
3/31/05	Fully address safekeeping concerns.
3/31/06	No DOR item.
3/31/07	No DOR item.

Note: There is no evidence to indicate that a safekeeping agreement was executed.

Table C-3

Legal Review of Safekeeping/Custodial Agreement

Examination or Contact Date	DOR Items
9/30/02	Legal counsel to ensure properly executed custodial agreement that protects the credit union's investment interests.
9/30/03	No DOR item.
6/30/04	No DOR item.
3/31/05	Attorney to review a true custodial agreement that protects the credit union's interests.
3/31/06	No DOR item.
3/31/07	No DOR item.

Note: The examiner indicated the credit union attorney reviewed the safekeeping agreement with no exceptions. However, the OIG could not locate such an agreement in the examiner's work papers.

Appendix D: NCUA Management Comments



National Credit Union Administration

VIA E-Mail

TO: William DeSarno, Inspector General
Office of Inspector General (OIG)

FROM: Executive Director David M. Marquis
Office of Executive Director 

SUBJ: Material Loss Review of New London Security Federal Credit Union

DATE: October 21, 2009

This memorandum responds to your request for review and comments on the OIG report titled *Material Loss Review of New London Security Federal Credit Union (MLR)*.

New London failed due to a misappropriation of credit union investment funds. New London management failed to establish the proper internal controls to provide adequate oversight over the investment account manager and the investment activity. The fraudulent act was allegedly perpetrated by the credit union's investment account manager, who controlled substantially all of the investment activity without adequate oversight. The MLR states the investment account manager made the investment purchase and sale decisions, executed investment transactions, and submitted reports and recommendations to the Board. In addition, the external auditor failed to challenge the authenticity of third-party confirmations, which may have detected the fraud sooner and mitigated the loss to the NCUSIF.

The MLR found that NCUA examiners recognized and addressed the issues at this credit union. Examiners repeatedly recommended the Supervisory Committee become more active or contract out quarterly reviews for such things as internal control reviews in the Documents of Resolution. NCUA examiners also recommended that the credit union execute a safekeeping/custodial agreement with a third party independent of the investment account manager. New London's management repeatedly failed to take timely corrective actions on the NCUA Documents of Resolution. We acknowledge the MLR's findings that the multiple instances of repeat DOR items, and the failure to take more stringent supervisory actions, may have resulted in missed opportunities to uncover the investment fraud, thus mitigating the loss to the NCUSIF.

Thank you for the opportunity to review and comment on the report.

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